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Mergers and acquisitions—maximizing the return on deals

The global insurance industry has seen mergers and acquisitions (M&A), big and small, continuing at a fast pace in recent years. In Canada, we saw Manulife buy John Hancock, catapulting the insurer into the position of the sixth largest global life insurer by market capitalization. In 2005 and 2006, there have been approximately 350 deals worldwide and more are expected in the near future.

The reasons behind acquiring and divesting of companies or blocks of business are manifold. Companies may find it necessary to gain scale, diversify their risk or divest themselves of non-core assets and thus increase their profitability. Increasingly, private equity players are also looking to the industry as a place to invest their excess funds.

But despite these valid business reasons for transactions, the odds are five to one that a merger or acquisition will not create value. Half of the deals since 1990 actually eroded returns to shareholders; only 17% have contributed significant value and 33% resulted in marginal returns.

Industry research shows that:

- 58% of mergers failed to reach goals set by top management;
- less than one quarter of transactions recovered the deal costs within ten years;
- the acquiring company did not earn back its cost of capital in almost 60% of all cross-border transactions;
- 50% of transactions resulted in same or lower profits; and
- shareholder wealth was destroyed in approximately half of 150 recent deals.

In more than half of unsuccessful M&A, failure occurred in the post-merger integration stage, when execution and speed are essential.

Best practices for M&A success requires that companies have a clear vision of the reason for the deal and how the acquisition, or divestiture, will support a broader long-term strategy. This will help to reduce the risk of making poor or uninformed decisions right from the beginning. Every possible facet of the acquisition target needs to be scrutinized, transaction pricing and structuring optimized, and M&A goals balanced with concerns for the employees.

Due diligence of a potential target helps to set negotiating guidelines, determine bid prices, assess risk and verify the financial and operational health of the target organization. The three key areas that due diligence needs to focus on are financial, tax and, in particular for insurers, actuarial.

Financial due diligence is more than just a review of an organization's audited financials. It looks at the quality of underlying management, the quality of historic earnings, potential exposures and risks, both on- and off-balance sheet. GAAP reporting differences and regulatory matters also have to be analyzed.

Tax due diligence identifies potential tax exposures and risks, issues associated with realization of balance sheet assets and opportunities to improve tax efficiency.

Actuarial due diligence covers a wide spectrum of factors, from reviewing the adequacy of reserves to studying pension transfer agreements. It also analyzes product profitability, cash flow projections, future benefit costs and current liabilities.

Post-deal challenges

Balancing integration with "business as usual"

Once the deal is done, companies must immediately focus on balancing the integration of the acquiree with business as usual. This is the key to the successful realization of the intended benefits and it requires addressing the challenges of value, risk and people.

Last year, a PwC survey found that post-deal integration is one of the most important factors for senior executives when considering M&A. Day-to-day business doesn't stop because of a transaction, no matter how big. Companies have to deliver both: benefits of the deal while keeping their focus on their core business and growth opportunities.

Integration framework

An effective framework for integration that helps in delivering the desired results includes several steps:

- Define a clear vision of integration success.
- Define integration strategy, including the degree of integration.
- Establish key objectives and targets.
- Put a governance and decision-making structure in place.
- Link with business operations and support functions.

Building this framework can help businesses overcome one of the biggest challenges in a merger or acquisition—capturing sustained economic value.

The first step is putting the right people, team and processes in place. Doing this early in the transition helps clarify authority, assign accountability and alleviate uncertainty.

It means having a clear vision of what integration success is and finding the answers to the following questions:

- Why are the companies integrating?
- What will integration success mean for key stakeholders, e.g. customers, employees, suppliers and shareholders?
- What are the priority initiatives?

Speed with focus makes the difference

Experience shows that acquisitions rarely fail due to flawed strategy. Instead, failure is most often a result of not executing the strategy in a timely fashion. Almost 80% of companies surveyed said they should have managed the transition faster; thus, speed is associated with fewer post-deal difficulties.

Transition speed also drives economic performance. Delays cost potential savings in synergies, savings that can quickly add up. If the company expects to achieve $100 million of annual synergies from the deal, every month of delay could cost more than $8 million. Every day of delay hurts the acquiror's bottom line, hence diminishing shareholder value.

Concentrating on key value drivers should form the basis for a combined business model; it focuses integration planning on what matters most.

This includes:

- building business cases for the key value driver initiatives;
- developing discrete work plans for integration execution;
- setting tasks, time frames, accountabilities and decisions;
- utilizing templates and processes for identification and prioritization; and
- tracking and measuring performance.

Resource considerations

Often, the time required of management and supporting staff once the deal closes is underestimated. A well-organized integration management team, which ideally involves people from both sides of the deal, is essential to a fast start. This team is responsible for identifying and designing the integration organization, establishing the integration management office, adopting a standard integration approach, and launching the communications process.

Since management's time is limited during integration, companies need to focus on priority initiatives and let shareholder value drive resource allocation. It comes down to defining the sources of value creation and allocating resources, based on their financial impact and the timeline. The key is to identify and focus efforts on the 20% of activities that will drive 80% of the value.

Prepare for "Day One"

Critical Day One tasks must be identified early to allow prompt identification of long lead items before they turn into closing day surprises. This requires that finance, human resources, regulatory compliance and other functions regularly liaise with the integration team.

It is imperative to separate the "Must Have" activities from the "Nice to Have" ones, as Day One draws closer. Must Have activities ensure either that the transaction closes on time or that business continues as usual on Day One.

Integration Process
Speed with focus makes the difference...

The key is to rapidly convert vision and strategy into detailed tactical plans.
The approach used must provide focus and facilitate the expedited capture of value.

Stakeholder communications

The period immediately following the announcement of the deal is vital for communicating to stakeholders. This is the time when perceptions are shaped and the flow of information from management is established. A robust communications plan that is driven by shareholder needs is an important part of a successful integration. It helps stabilize the organization, builds support from stakeholder groups and engages all business departments during the transaction. Identifying all the stakeholders impacted by the transaction and understanding their communications needs is an essential first step.

For insurance companies, stakeholders would normally include policyholders, investors, regulators, brokers/agents and employees. To achieve a smooth integration, key stakeholder issues should be identified and a communications plan developed that proactively manages these issues.

Looking ahead

As the rate of M&A is expected to continue, or even escalate, in particular in the Canadian property and casualty insurance industry, insurers need to understand the pitfalls prior to making a deal. The competition is increasing exponentially and the need to achieve synergies has never been greater. To make integration successful, the optimum combination of strategy, people, processes, technologies and facilities needs to be in place.

Above all, speed with focus makes the difference. Delays not only cost money, but also can sow seeds of doubt in the minds of stakeholders that the deal was a sound move. Companies that move swiftly and decisively can drastically improve their odds for success—and the returns to their shareholders.

Embracing customer centricity—narrowing the distance between you and your customer

Imagine a business that consistently puts customers at the heart of its operations—customers it has won in a highly competitive market with increasingly narrow margins. A business that identifies the market's most attractive clients, provides desired products and services to new and existing customers, expands its customer base year over year, increases its share of customers' wallets and grows customer satisfaction scores along the way. Does this sound like a vision for your business?

Or, does this sound more representative of your business challenges?

Due to a fiercely competitive market, compounded by formidable customer expectations, increasingly onerous regulatory requirements and heightened profitability pressures that continue to escalate, you struggle to make your customers the focal point of your operations.

Market changes, regulatory demands and competitors' tactics aside, the business reality for financial institutions is that customers continue to raise the bar in terms of needs and expectations, and your customers expect you to clear that bar.

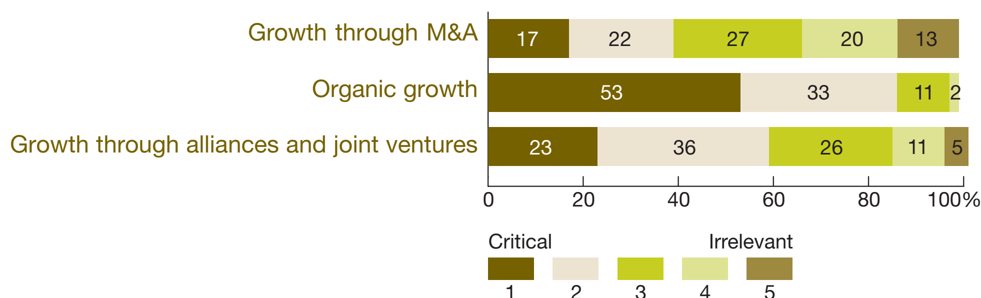
Growing your business in such a challenging environment increasingly demands a sharp focus on the customer—it's no surprise then that customer centricity is quickly becoming a top priority for business leaders. A PwC survey of approximately 250 financial institutions' executives from around the globe found the following:

- Nearly one third of respondents said that 5%–10% of their customer base voluntarily leaves each year.
- 48% stated that poor IT infrastructure is the principal barrier to turning their companies into more customer-centric organizations.
- 38% said their organizations are structured around products, not customers.
- 33% cite a lack of good information on customer satisfaction and expectations.

These results do not bode well for over half of those respondents who identified organic growth as their number one strategy to achieve growth targets in the near term.

PwC Survey Results

Which of the following strategies will be most important to your organization as it seeks to achieve its growth targets over the next three years?



Please note that totals do not always add up to 100 because of rounding, or because respondents could choose more than one answer.

Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, April 2006

An effective approach for formulating a customer-centric blueprint is to begin by bridging the gap between thought and execution—create actionable steps, which leading businesses have taken in building customer-centric capabilities. By envisioning what your customers should experience if they turn to your organization to satisfy their needs, and translating that into business practices, you will have taken a critical step in moving the customer to the center of your operations.

A good start to determine your organization's "customer-centric maturity" is grading your company against five key capabilities that leading organizations have developed when striving to become customer-centric:

1. Provide front-line staff with a complete overview of the customer and manage customer information as a strategic asset.
2. Sales and service is based on identifying customer preferences and expectations.
3. Integrate across business units to enable cross-product line collaboration and cross-selling capabilities.
4. Manage the customer experience to provide a common and consistent customer experience across touchpoints.
5. Measure customer value.

The path to becoming more customer-centric is difficult to navigate. Consider the multi-million dollar investments that many Canadian insurers and banks have made to improve their customer-centric/customer relationship management (CRM) capabilities over the last five to ten years. It began with integrated customer information capabilities, followed by variations of enterprisewide, multi-product lines, multi-channel CRM systems—with mega price tags, lengthy implementations, and the associated re-engineering and human capital investments which may, or may not, have survived the cost-cutting knife along the way.

Organizations continue to look for ways to leverage these large IT investments, and the jury is still out as to whether customers realize true value from these investments.

Both insurance companies and banks have come to the conclusion that focusing on the customer is crucial to their success. However, the large technology solutions expected to deliver the holy grail of customer centricity have not delivered expected results; some companies have faced long and complex implementations, incurring extreme costs without generating the expected positive customer impact. The key learning was that customer centricity cannot be reached through technology alone.[1]

Achieving customer centricity requires successful strategies to address various challenges: organizational design, relationship management and market segmentation, staff behaviour and cross-lines-of-business processes.

1 Celente Article, "A Fresh Start to Customer Centricity", June 2005.

In short, customer centricity is a cultural destination, requiring strong executive vision, sponsorship, a well-articulated business case and a carefully considered organizational blueprint and road map if to be arrived at successfully. The challenges are formidable; however, the reality remains that successful businesses realize that their top priority is the customer—and organizations, which have made real progress in narrowing the gap between their business and their customers, have put their customers' expectations at the top.

Insurers spend a considerable amount of time and effort on their claims function, one process that requires extensive resources to manage and execute, and that has a significant impact on profitability and customer satisfaction. Business leaders understand that timely and accurate claims resolution will have a positive impact on both measures.

The Progressive Corporation (Progressive), based in Mayfield Village, Ohio, experimented with new ways of expediting claims resolution through building a crew of roving "immediate response vehicles" (IRVs) and claims adjustors, who respond to policyholders' calls directly and immediately at the scenes of accidents.

Over the ten-year life of the project, Progressive reports a 100% boost in productivity for its claims adjustors, an increase in revenue from US$1.8 billion to US$9.0 billion and a 20% lift in customer retention, an indication of an improved focus on the customer. By combining the appropriate skillset, enabled by technology and incentives to deliver a more expedient service, Progressive was able to get much closer to its customer base, striking the difficult target of providing better service profitably.

The necessity to understand customer needs and removing product silos in order to deliver a more complete, satisfactory—and profitable—service has resulted in changes to the way services are delivered. In the 90s, the advent of accident management companies, claims managers who manage the entire claim rather than specific activities, was the first step for insurers to fold additional services into the claims management process.

Direct Line Insurance acquired a roadside assistance company to offer breakdown and recovery services under the same brand and at the same time as claims services, a trend that sets up a more complete solution, reflecting a better understanding of customer needs, while delivering more products and services to customers.[2]

Measuring and managing customer value is a critical capability in being able to balance service provision and customer profitability. The ability to align the cost of services with customer value will facilitate improved profitability across the customer segmentation strategy. Segmenting the claims portfolio allows insurers to separate claims by value and respond accordingly, improving both customer satisfaction and employee productivity. Leading insurers will spend more time and attention, e.g. cross-selling, on high-net-worth policyholders or those who purchase multiple products—aligning higher cost

2 PwC Global Best Practices

delivery approaches with high value customers. Conversely, this organizational delivery model can be designed to route high-volume, lower-value claims through low-cost service centers, which employ rules-based systems.

A single, positive experience from a customer's perspective can result in exponential gains for an insurer because satisfied customers not only remain loyal customers, but also spread the word about a good experience and are open to purchasing additional offerings.

An organization that can effectively identify high-value customers and profitably deliver a positive experience, based on meeting and exceeding their expectations, will enjoy a growing and profitable customer base.

Charting a course to develop the core customer-centric capabilities is not an easy task. Your approach must be built on an understanding of your current capabilities, core competencies and culture.

To begin the process, it may be advisable to target a business unit within your organization and build from there, thus avoiding mega project challenges and pitfalls. While the task may seem daunting, the risk of not investing toward gaining a better understanding of customer needs—and exceeding them in a profitable way—is far greater. Chances are, your competitors are looking carefully at their ability to satisfy their best customers, and win new ones, perhaps yours—and they are addressing those gaps.

Offshoring—the ongoing quandary for insurance companies

For Canadian insurers who consider the potential of offshoring, a top-of-mind issue is the extent to which it makes business sense, given the complexities and risks involved. Although the initial labour arbitrage may appear attractive, the deeper analysis typically focuses on problematic areas that, in addition to political and currency risk, can include tax implications, regulatory, operational and management requirements, language and business process knowledge.

A key challenge for many insurers in the Canadian marketplace is finding sufficient scale in a particular business area that justifies the investment and generates adequate risk-adjusted returns. This continues to hamper the penetration of offshoring in underwriting, claims, call centres and finance.

On the other hand, many large insurers have had success in offshoring IT application development and maintenance, and several are beginning to use their offshore partners in a transformation effort.

Experience has spawned a growing recognition that many of the realized benefits actually come from standardization, consolidation and centralization efforts—and that these advantages can be gained within Canada, without necessarily taking the final step of moving offshore.

There is also the fact that, although not widely recognized, Canada remains a significant destination for nearshoring of business processing outsourcing and call centres for US companies. Governments, particularly in Ontario and eastern Canada, have made significant progress in developing incentives and infrastructures for call centres; this was recently validated when Admiral Insurance from the UK established its new centre in Halifax, Nova Scotia.

The key for any Canadian insurer is to thoroughly weigh the advantages and risks for both offshoring and nearshoring alternatives.

Current tax and accounting developments

Recent tax highlights

Both the federal government and the Government of Ontario in their recent budgets introduced various tax measures that will impact Canadian insurers. Although legislation has not yet been enacted, the changes are likely to impact 2007 taxable income. We will address relevant developments in future issues of Insurance Review.

Federal budget

Interest deductibility for financing investments in foreign affiliates

Under current rules, Canadian corporations do not pay Canadian income taxes on foreign-source active business earnings (exempt surplus) of a foreign affiliate. Canadian corporations are permitted to deduct interest expense on debt that is incurred for the purpose of acquiring shares or debt of a foreign affiliate.

The budget proposes to restrict the immediate deduction of interest expense on money borrowed or indebtedness incurred by corporations to invest in debt or equity of a foreign affiliate. Interest expense will be pooled for deduction (net of exempt surplus received), if those investments in the foreign affiliate generate non-exempt income for the corporation. In addition, the rule will ensure that indirect financing cannot be used to avoid the application of this policy.

The restriction on interest deductibility will apply to interest payable after 2007 on new borrowings or indebtedness incurred after March 18, 2007 (other than a borrowing or indebtedness, pursuant to an agreement in writing entered into before March 19, 2007). For existing debt, the restriction will apply after the earlier of the expiry of its current term and December 31, 2008 (for non-arm's length debt) or December 31, 2009 (for arm's length debt).

Elimination of withholding tax on interest

Formal negotiations to update the Canada/US tax treaty are expected to conclude in the very near future. A major element that has been agreed to in principle is the elimination of withholding tax on interest.

Under the proposed agreement, once the changes are fully phased in, cross-border interest payments will no longer be subject to tax by the country where the payor of the interest resides. The Canada/US tax treaty currently allows a withholding tax rate of up to 10%. Under the proposed agreement, interest paid on arm's-length debt will not be subject to withholding tax, beginning in the first calendar year following the entry into force of the treaty changes. For interest payments to non-arm's-length persons, the maximum withholding rate will be reduced to 7% in the first year following the entry into force of the treaty, to 4% in the second year, and eliminated for the third and subsequent years. The budget proposes that Canadian withholding tax be eliminated on interest paid to all arm's-length non-residents, regardless of their country of residence, once the Canada/US tax treaty is ratified.

Ontario budget

Changes to accounting rules—unrealized gains and losses

Recent changes to Canadian accounting rules require corporations to report certain assets at fair market value rather than historical cost, with gains or losses accruing on an asset held at the end of the fiscal period recognized in net income in that period. For taxation years ending after March 22, 2007, the budget proposes to amend the Corporate Minimum Tax (CMT) rules to remove the effect of these accounting changes. The result is that income for CMT will be calculated without reference to unrealized gains and losses that are not required to be included in computing income for income tax purposes.

As well, on December 28, 2006, the federal Department of Finance issued a press release announcing tax changes to the treatment of both debt securities and insurers' tax reserves. The tax changes include the timing of recognition of unrealized gains and losses on debt securities. To date, draft legislation has not been released. The computing of income for income tax and CMT purposes for insurers will be subject to the pending legislation. (For a more detailed discussion of the accounting and financial reporting changes and related tax and regulatory developments arising from the suite of new accounting standards for financial instruments please refer to our year-end 2006 edition of Insurance Review.)

IFRS accounting for insurance contracts

On May 3, 2007, the International Accounting Standards Board (IASB) launched the discussion paper *Preliminary Views on Insurance Contract*s for public consultation. This is a critical step forward towards the development of International Financial Reporting Standards (IFRS) specific to insurance companies, which could have significant implications for Canadian insurance companies with the upcoming adoption of IFRS in Canada by 2011. The public consultation period will be six months and will aid the IASB in developing firm proposals for an exposure draft, which is expected to be published towards the end of 2008.

Stay tuned for further analyses and comments on the discussion paper.

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